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INTERNATIONAL INSIGHT

August 2014

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Foreign Account Tax Compliance Act (FATCA) Developments

By Scott A. Bowman

FATCA is finally here. July 1, 2014 ushered in the first withholding obligations under the Foreign Account Tax Compliance Act ("FATCA"). Under the regulations now in effect, payors of U.S. source withholdable payments to certain non-U.S. entities are required to obtain FATCA documentation or impose a 30 percent withholding tax.

FATCA was enacted in 2010 in response to ongoing challenges in combating U.S. tax evasion through the use of foreign financial accounts. These challenges were particularly highlighted by the investigation of several non-U.S. financial institutions, including UBS AG, and the overwhelming responses to the IRS "Offshore Voluntary Disclosure Initiative." The intent of FATCA is to enlist financial institutions into cooperating with U.S. tax reporting, or face significant ramifications in the form of U.S. tax withholding.

Specifically, certain foreign entities must identify, document, and report their U.S. account holders to the IRS (or local tax authorities) or face a 30 percent withholding tax on U.S. source withholdable payments. These U.S. source withholdable payments include items such as interest, dividends, rents, and annuities. Gross proceeds from the sale or exchange of property that produces this type of income will become subject to FATCA beginning on January 1, 2017.

For FATCA purposes, foreign entities are classified as foreign financial institutions ("FFIs") and non-financial foreign entities ("NFFEs"). The compliance obligations under FATCA vary depending whether an entity is an FFI or NFFE. FFIs consist of five types of entities: depository institutions; custodial institution; specified insurance companies; investment entities; and certain holding companies. Any foreign entity that is not an FFI is an NFFE. Many private client structures may inadvertently be swept into the investment entity or holding company category. As such, their compliance obligations may be more onerous than what a cursory compliance review of the structure may indicate.

Many of these entities were required to register with the IRS prior to May 5, 2014 in order to obtain a global intermediary identification number ("GIIN"). Certain entities are exempt from registration on account of their classification as NFFEs or alternative compliance requirements promulgated under intergovernmental agreements ("IGAs") entered into between various countries and the U.S.. Regardless of classification, FFIs and NFFEs are required to provide a completed Form W-8BEN-E to payors of U.S. source withholdable payments. Failure to provide a completed Form W-8BEN-E will subject such payments to FATCA withholding.

Insurance companies are generally treated as FFIs if they issue or are obligated to make payments with respect to a cash value or annuity contract. For purposes of FATCA, an insurance company is any company: that is regulated as an insurance business under the law, regulations, or practices of any jurisdiction in which the company does business; the gross income of which arising from insurance, reinsurance, and annuity contracts exceeds 50 percent of its total gross income; or the aggregate value of the assets of which associated with insurance, reinsurance, and annuity contracts exceeds 50 percent of its total assets. An insurance or annuity contract is treated as an account for FATCA reporting purposes.

Although due diligence procedures will vary depending on whether an FFI or NFFE is resident in an IGA jurisdiction, information gathering and reporting under the FATCA regulations generally includes each account holder's name, address, taxpayer identification number, the account number and account balance, and the gross receipts and withdrawals or payments from the account. These reporting requirements may be carved back under the terms of an IGA.

Insurers, producers and clients alike should anticipate some significant market changes on account of FATCA. At the very least, client intake procedures and due diligence will become much more onerous and time consuming, opening market share for insurers and producers who can streamline the process for more efficient intake. This includes reviewing current procedures to ensure that all appropriate FATCA information is being gathered. Additionally, as the implications for compliance and disclosure develop over the coming months, investments are likely to shift into strategies that may provide greater privacy. Look for cash value policies and annuities to be a potentially attractive option for clients seeking less disclosure.

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